No. 80-1468

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# In the Supreme Court of the United States

OCTOBER TERM, 1980

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BARRY L. BATTELSTEIN AND JERRY E. BATTELSTEIN,
PETITIONERS

*v.*

INTERNAL REVENUE SERVICE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

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## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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## TABLE OF AUTHORITIES

Page

Cases:


*Beck* v. *Commissioner*, 45 T.C. 1534 ..... 6

*Brown* v. *United States*, 396 F. 2d 459 ..... 4-5

*Burck* v. *Commissioner*, 533 F. 2d 768, aff'd, 63 T.C. 556 ..... 5

*Burgess* v. *Commissioner*, 8 T.C. 47 ..... 5, 6, 7

*Cleaver* v. *Commissioner*, 6 T.C. 452, aff'd, 158 F. 2d 342, cert. denied, 330 U.S. 849 ..... 3

*Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569 ..... 3

*England* v. *Commissioner*, 34 T.C. 617 ..... 3

*Goodstein* v. *Commissioner*, 267 F. 2d 127, aff'g, 30 T.C. 1178 ..... 4, 7

*Gregory* v. *Helvering*, 293 U.S. 465 ..... 4

*Hart* v. *Commissioner*, 54 F. 2d 848 ..... 3

*Helvering* v. *Price*, 309 U.S. 409 ..... 3

*Hoboken Land & Improvement Co.* v. *Commissioner*, 138 F. 2d 104 ..... 4

*Hopkins* v. *Commissioner*, 15 T.C. 160 ..... 3

*Johnson* v. *Commissioner*, 86 F. 2d 710 ..... 4

*Keith* v. *Commissioner*, 139 F. 2d 596 ..... 3

*Lynch* v. *Commissioner*, 273 F. 2d 867 ..... 4

*Miles* v. *Livingstone*, 301 F. 2d 99 ..... 5

*Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609 ..... 5

Page

Cases—Continued:

*Nat Harrison Associates, Inc.* v. *Commissioner*, 42 T.C. 601 ..... 3

*Rubnitz* v. *Commissioner*, 67 T.C. 621 ..... 3

*Wilkerson* v. *Commissioner*, 70 T.C. 240 ..... 5

Statute:

Internal Revenue Code of 1954 (26 U.S.C.):

Section 163 ..... 1, 2
Section 163(a) ..... 6
Section 446 ..... 6

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The question presented in this factual income tax case is whether the giving of a borrower's note for the amount of interest due on a prior loan, simply because it is accompanied by a prearranged exchange of offsetting checks between debtor and creditor, amounts to payment of interest so as to be deductible by cash basis taxpayers under Section 163 of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts may be summarized as follows: Petitioners were land developers who reported their income for tax purposes on the cash receipts and disbursements method of accounting. In 1971, Gibraltar Savings Association agreed to lend petitioner more than three million dollars for the purchase of a piece of property. Gibraltar also agreed to make further loans in the future to cover costs of

holding the property, including interest payments on the original loan. In partial consideration for its participation, Gibraltar was to receive 19% of the profit from the sale of the property (Pet. App. A-3, A-17 n.1).

Pursuant to this agreement, Gibraltar notified petitioners of the current interest due each quarter. Petitioners then sent Gibraltar a check for that amount and Gibraltar, in turn, sent petitioners its own check in the identical amount (Pet. App. A-3). Petitioners executed notes for each of the additional loans (Pet. App. A-3 to A-4). Petitioners claimed interest deductions for 1973 and 1974 on the ground that these checks to Gibraltar constituted payments of interest under Section 163.[1] In 1976 and 1977, petitioners filed Chapter XI petitions in bankruptcy. The Internal Revenue Service filed claims against each petitioner based, in part, on the Commissioner's disallowance of these interest deductions (Pet. App. A-33 to A-34). The bankruptcy court upheld petitioners' right to the interest deductions on its findings that Gibraltar had no control over the funds advanced to petitioners (Pet. App. A-35); that petitioners had other funds with which they could have paid the interest liability (Pet. App. A-38 to A-39); that the funds advanced to petitioners were commingled with other funds in petitioners' bank accounts (Pet. App. A-39); and that the underlying transaction had "economic utility" (*ibid.*). The district court affirmed (Pet. App. A-29).

The court of appeals, after rehearing en banc, reversed. It concluded that despite the exchange of checks, which resulted in petitioners' satisfying their interest obligations, "[t]he law leaves no doubt that such a surrender of notes

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[1] Barry Battlestein capitalized his portion of the interest for 1974 (Pet. App. A-25).

does not constitute payment for tax purposes entitling a taxpayer to a deduction" (Pet. App. A-5).[2]

1. The decision below correctly held that petitioners were not entitled to a deduction for interest paid with notes. This Court has long held, and has recently reaffirmed, that giving a note is not such payment by a cash basis taxpayer as to give rise to a deduction against gross income. *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569 (1977); *Helvering* v. *Price*, 309 U.S. 409 (1940). "The reasoning is apparent: the note may never be paid, and if it is not paid, 'the taxpayer has parted with nothing more than his promise to pay.' " *Don E. Williams Co., supra*, 429 U.S. at 578, citing *Hart* v. *Commissioner*, 54 F. 2d 848, 852 (1st Cir. 1932). This rule has been broadly applied to transactions that, in substance, result in a taxpayer's giving his note in lieu of a cash payment of interest, whether by discounting the original loan, *Rubnitz* v. *Commissioner*, 67 T.C. 621 (1977); *Hopkins* v. *Commissioner*, 15 T.C. 160 (1950); *Cleaver* v. *Commissioner*, 6 T.C. 452, aff'd, 158 F. 2d 342 (7th Cir. 1946), cert. denied, 330 U.S. 849 (1947); by increasing the principal of a loan by the amount of interest currently due on the loan, *England* v. *Commissioner*, 34 T.C. 617 (1960); or by withholding the interest due on a previous loan from the same lender, *Keith* v. *Commissioner*, 139 F. 2d 596 (2d Cir. 1944); *Nat Harrison Associates, Inc.* v. *Commissioner*, 42 T.C. 601 (1964).

Petitioners lose sight of the fact that, with the exception of their reliance upon the exchange of checks, all of their arguments are nothing more than an attack upon the rule established by this Court in *Helvering* v. *Price*, *supra*, and *Don E. Williams Co.* v. *Commissioner*, *supra*. Thus, for

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[2]The original panel of the Fifth Circuit had reversed the district court on substantially the same ground (see Pet. App. A-20).

example, petitioners argue (Pet. 7) that the source of borrowed funds used to pay a debt is not relevant, and (Pet. 10-12) that the holding below will impede and discourage commerce. But if petitioners were to prevail here, the rule announced by this Court would be emasculated because any taxpayer wishing to defer payment of a debt and still obtain a tax deduction for interest could readily arrange for the meaningless exchange of checks that occurred in this case.

2. Petitioners further argue (Pet. 5-7) that the court of appeals created an unwarranted exception to the general rule that payment by check is equivalent to payment by cash for tax purposes. This is clearly not the case. Petitioners issued their checks to Gibraltar pursuant to an agreement whereby Gibraltar would return to them checks in identical amounts. In ignoring this exchange for tax purposes, the court of appeals was not holding that checks are not cash equivalents for tax accounting purposes. To the contrary, it concluded that the checks were irrelevant to the transaction. In so ruling, the court applied the principle announced by this Court in *Gregory* v. *Helvering*, 293 U.S. 465 (1935), that a form or device that is devoid of economic substance may be disregarded for tax purposes.[3]

Exchanges of offsetting paper have been disregarded as merely paper transactions in a number of contexts. See, *e.g.*, *Hoboken Land & Improvement Co.* v. *Commissioner*, 138 F. 2d 104, 109-111 (3d Cir. 1943); *Johnson* v. *Commissioner*, 86 F. 2d 710 (2d Cir. 1936). And they have frequently resulted in the denial of interest deductions. See, *e.g.*, *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1st Cir. 1959); *Lynch* v. *Commissioner*, 273 F. 2d 867, 869 (2d Cir. 1959);

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[3]At all events, the decision below does not rest upon a distinction between a tender of a check and a tender of cash. An exchange of actual cash with the lender, in lieu of the exchange of checks, would likewise be disregarded and would not entitle petitioners to a deduction.

*Brown* v. *United States*, 396 F. 2d 459 (Ct. Cl. 1968), and the many cases cited therein. Cf. *Miles* v. *Livingstone*, 301 F. 2d 99 (1st Cir. 1962). The exchange of offsetting checks in the instant case was properly ignored for tax purposes. As this Court observed in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

Here, petitioners and Gibraltar trod no path, straight or circuitous. They remained where they were. Petitioners' debts, for principal and for interest, were the same before and after their exchanges of checks, and interest deductions were properly denied. Petitioners contend (Pet. 10-12) that the court of appeals' decision would create commercial uncertainty and impede commerce. But the court of appeals' rejection of meaningless paper shuffles will surely not impede bona fide commercial activity. Indeed, petitioners themselves concede (Pet. 10-11) that a sham transaction may be disregarded for tax purposes.[4]

3. Petitioners also contend (Pet. 4) that the decision below conflicts with *Burck* v. *Commissioner*, 533 F. 2d 768 (2d Cir. 1976), aff'd, 63 T.C. 556 (1975), as well as with *Burgess* v. *Commissioner*, 8 T.C. 47 (1947), and *Wilkerson* v. *Commissioner*, 70 T.C. 240 (1978), appeal pending, No.

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[4]The bankruptcy court's determination (Pet. App. A-39) that the underlying transaction had "economic utility" is beside the point. There may have been a valid loan, but no economic purpose was ever found for the exchange of checks that purportedly paid the interest. The argument of the dissenting opinion in the court of appeals (Pet. App. A-11) that the loans had a business purpose is similarly inapposite. It is the exchange of checks that is meaningless and was properly ignored by the majority—not the underlying loan. Indeed, the transactions in *Price* and *Williams*, had the same economic utility claimed by petitioners—they enabled the taxpayers to retain cash which would otherwise have passed to the lender and to use that cash for other bona fide commercial purposes.

79-7519 (9th Cir.). But the dictum in *Burck* actually supports the decision below. In *Burck*, the taxpayer borrowed $3,000,000 from the Bank of Commonwealth, $1,000,000 of which was transferred by wire to taxpayer's account with First National City Bank. On the next day, the taxpayer transferred $377,000 back to Commonwealth as prepayment of interest on the $3,000,000 loan and on another loan that taxpayer had taken from Commonwealth. The Tax Court, citing its earlier decision in *Burgess* v. *Commissioner, supra*, sustained the theoretical correctness of the taxpayer's interest deduction because the proceeds of the second loan were commingled with other funds and thus were not directly traceable to the interest payment. The court further relied on its findings that taxpayer possessed substantial other assets with which he could have paid the interest (63 T.C. at 560).

The Tax Court also held, however, that only 3/365 of the interest was allowable in the year in issue, because the remainder was prepaid interest that materially distorted the taxpayer's income and was properly disallowed by the Commissioner under Section 446 of the Code. The taxpayer's appeal in *Burck* was limited to this second issue. The majority opinion of the Second Circuit, which ruled in favor of the Commissioner on the Section 446 issue, also stated in dictum that the Tax Court's treatment of the Section 163(a) issue was incorrect. Thus, contrary to petitioners' representation (Pet. 4-5), to the extent that the Second Circuit addressed the issue at all, its opinion supports, rather than conflicts with, the decision below. Indeed, in a subsequent citation to *Burck* in support of the *Burgess* rule (Pet. 8), petitioners concede that *Burck* was affirmed on other grounds.

Moreover, the Tax Court's reasoning in this line of cases is unsound and contrary to the teaching of this Court in *Price* and *Williams*. The Tax Court itself has taken note

that *Burgess* "has been the subject of some criticism." *Beck* v. *Commissioner*, 45 T.C. 1534, 1565 (1980). It has never been approved by any appellate court. In addition to the decision below and the dictum of the Second Circuit in *Burck*, the First Circuit in *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1959), aff'g 30 T.C. 1178 (1958),[5] expressly approved the position of the dissenting judges in *Burgess*, who concluded that the exchange of checks in that case was a nullity and that the transaction was governed by the general rule that a cash basis taxpayer who pays interest on a debt with funds borrowed from the same creditor has not made a cash payment of interest which is deductible from gross income (8 T.C. at 51). In sum, *Burgess* and its progeny have been universally disapproved by the courts of appeals.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
*Solicitor General*

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[5]The Tax Court in *Goodstein* noted, without discussion, that *Burgess* was distinguishable on its facts (30 T.C. at 1192).